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Balance, Accountability, and Responsiveness

Lessons about Decentralization

Anwar Shah

Decentralized fiscal structures are more suitable in developing countries than centralized structures are, especially when they are supported by strengthening the rule of law, an independent central bank, an independent judiciary, a charter of rights, appropriate limits on various levels of government, institutions for conflict resolution and for the evaluation of government efforts at all levels, and mechanisms (including a free media) for listening and making government accountable to the citizenry.

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Summary findings

Shah examines the reasons developing countries are reexamining the respective roles of the private sector, civil society, and various levels of government — and considering new fiscal arrangements between national and lower levels of government.

Decentralization may be particularly well-suited to developing countries, where central governments are not as well developed as in industrial countries — because information requirements and transaction costs are lower at lower levels of government and the government can be more responsive and accountable to the citizenry.

Vital to the success of decentralized decisionmaking, says Shah, are:

- A broad public consensus that decentralization is appropriate.
- Civil service reform designed to encourage a service orientation, to discourage command-and-control governance and rent-seeking, and to prevent the central government from have a direct say in the recruitment and promotion of subnational civil servants.
- Proper monitoring and oversight of governance.

Other lessons from experience:

- When there is citizen participation and transparency in decisionmaking, limited budgeting, auditing, and accounting systems at the subnational level should not be considered a barrier to decentralization. Those technical capabilities can be borrowed from higher levels of government.
- Indonesia and Pakistan provide good examples of “asymmetric” decentralization, in which various powers can be assigned to different levels of government, depending on capacity.
- The delinking of taxing and spending decisions leads to lack of accountability in the public sector.
- Revenue-sharing (tax by tax) distorts incentives for efficient tax collection.
- Properly structured (simple, transparent, consistent with objectives) fiscal transfers can improve government accountability. Fiscal transfers can also be used to encourage competition for the supply of public goods. In Canada and Chile, for example, Catholic schools compete with public schools for financing.

This paper — a product of the Country and Regional Evaluation Division, Operations Evaluation Department — is part of a larger effort in the department to learn lessons of evaluation in improving public sector performance in developing countries. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Anwar Shah, room G6-079, telephone 202-473-7687, fax 202-522-3124, Internet address ashah@worldbank.org. December 1998. (41 pages)

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Balance, Accountability, and Responsiveness:

Lessons about Decentralization

by

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1. Introduction

During the past half a century, by subscribing to various variants of central planning paradigms of development, developing countries, by and large, followed a path of centralization and as a result, they are more centralized today than industrialized countries were in their early stages of development (Boadway, Roberts and Shah, 1994). A number of recent developments, discussed below, are prompting most developing countries to re-examine the respective roles of various levels of government, the private sector and the civil society as partners in development. This rethinking has caused much heated controversy and debate in development policy fora. Regrettably, this debate has focused on straw men of "centralization" Vs "decentralization" (see Prud'homme 1995, Tanzi 1996, Sewell, 1996 and McLure, 1995) and ignored the precepts of federalism that appropriate institutions and mechanisms must be introduced in support of the constitutional assignment of responsibilities in multilevel or multicentered governments. It must be noted that contrary to focus in the above mentioned debate, the federalism literature is concerned with seeking optimal assignment of responsibilities among different levels of government in support of good governance (see Shah, 1994). This paper examines the reasons for a rekindling of an interest in fiscal rearrangements in both industrial and non-industrial countries. It reflects upon the debate on the "dangers of decentralization" by providing an evaluation of the decentralization experience using a systemic framework. It draws general and institutional lessons to enhance the effectiveness of decentralization as a means to foster listening, learning and evaluation environment for responsive and accountable governance. An overall conclusion of the paper is that decentralized fiscal structures are more suitable in the institutional environment of developing countries especially so if careful attention is paid to the design of institutions vital for the success of decentralization policies such as the rule of law, conflict resolution and coordination, charter of rights, effective limitations on the authority of governments beyond their designated spheres of influence, accountability and institutional capacity for evaluation at all levels.

2. The Quest for the Right Balance

The reasons for rethinking fiscal arrangements are manifold and the importance of each factor is country specific. Nevertheless, generic catalysts for change include the demise of communism, desire to breakaway from the vestiges of colonialism as in Africa, national

government failures, subnational government failures, assertion of basic rights by the courts, globalization of economic activities and the demonstration effects of the European Union and Latin America (see Picciotto 1995, Shah, 1995). The demise of communism prompted a major change in government organization and geographical boundaries of some countries especially in Eastern Europe and former Soviet Union. These countries sought guidance from the principles and practices pursued in industrialized countries where federal systems of decision making have evolved over a long period of time. In Africa, both former French and English colonies inherited highly centralized systems of governance geared towards command and control and against responsiveness to public at large. In most countries, national governments have failed to ensure regional equity, economic union, central bank independence, a stable macroeconomic environment or local autonomy. The record of subnational governments is also not very commendable. Subnational governments have often followed beggar-thy-neighbour policies, sought to seek free ridership with no accountability and, in pursuit of narrow self-interest, often undermined national unity.

The judicial systems in some countries are also providing stimuli for change by providing a broader interpretation of basic rights and requiring that national and subnational legislation conform to the basic rights of citizens. The emergence of a new "borderless" world economy complicates this picture by bringing new challenges to constitutional federalism (see Courchene 1995). These challenges arise from the decline of nation states in carrying out regulation of certain economic activities as borders have become more porous and information technology has weakened their ability to control information flows. The European Union's policies and principles regarding subsidiarity, fiscal harmonization and stabilization checks are also having demonstrable effects on country policies. Similarly the success of decentralization in improving efficiency and equity of public provision and accountability of the public sector in some Latin American countries especially Colombia and Chile has encouraged other countries to have a review of own fiscal arrangements (see Wiesner, 1994). Finally, resurgence of interest in the federalism principles and best practices has served a powerful basis to restructure and re-orient public sector.

Globalization of economic activity poses special challenges to constitutional assignment discussed above. With globalization, it is increasingly becoming apparent that nation states are too small to tackle large things in life and too large to address small things. More simply nation states are fast losing control of some of their areas of traditional control and regulation such as regulation of external trade, telecommunications, and financial transactions. National governments are experiencing diminished control in their ability to control the flow of goods and services, ideas and cultural products. These difficulties are paving way for the emergence of specialized institutions of global governance such as the World Trade Organization, Global Environmental Facility with many more to follow especially institutions to regulate information technology, satellite communications, and international financial transactions. Thus nation states would be confederalizing in the coming years and relinquishing responsibilities in these areas to supranational institutions.

In the emerging borderless world economy, interests of residents as citizens are often at odds with their interests as consumers. In securing their interests as consumers in the world economy, individuals are increasingly seeking localization and regionalization of public decision making to better safeguard their interests. With greater mobility of capital, and loosening of regulatory environment for foreign direct investment, local governments as providers of infrastructure related services would serve as more appropriate channels for attracting such investment than national governments.

With mobility of capital and other inputs, skills rather than resource endowments will determine international competitiveness. Education and training typically however is subnational government responsibility. Therefore, there would a need to realign this responsibility by giving the national government a greater role in skills enhancement. The new economic environment will also polarize the distribution of income in favor of skilled workers accentuating income inequalities and possibly wiping out lower middle income classes. Since the national governments may not have the means to deal with this social policy fallout, subnational governments working in tandem with national governments would have to devise strategies in dealing with the emerging crisis in social policy.

International trade agreements typically embody social policy provisions. But social policy is typically an area of subnational government responsibility. This is an emerging area for conflict among different levels of government. To avoid these conflicts , a guiding principle should be that to the extent these agreements embody social policy provisions they must be subject to ratification by subnational governments as is currently the practice in Canada.

The information revolution is leading to a decrease in transaction costs and therefore lowering of costs to correct for information asymmetries and of writing and enforcing better contracts (see Eid, 1996). Hart (1995) has argued that in such a world organizational form is of lesser consequence and therefore, as a consequence, the need for decentralized institutions is diminished. Globalization of information -- satellite TV, internet, phone and fax -- serve also to enhance citizens' awareness of their rights, obligations, options and alternatives.

The overall impact of these influences is to force a rethinking on assignment issues and to force a jurisdictional realignment in many countries around the globe. Appendix Tables A1-A3 present a newer federalism perspective on the assignment of responsibilities and the design of transfers by taking into account the considerations noted above. These tables show that at the conceptual level some functions such as regulation of financial transactions, international trade, global environment, international migration need to be passed upwards (centralized) beyond nation states, some subnational functions such as training should have greater central government inputs (centralization) and local functions should be completely decentralized and should involve greater participation by the civil society and the private sector. In developing countries, rethinking these arrangements has led to gradual and piecemeal decentralization of responsibilities for local public services to lower levels in a small but growing number of countries. The development and strengthening of institutional arrangements for the success of decentralized policies has significantly lagged behind. It is remarkable that with the single exception of Colombia, no other developing country has paid any attention to developing the institutional capacity for evaluation. Even strengthening of central and intermediate level functions required for the success of this realignment have not always materialized. In fact in some countries, decentralization is motivated by shifting the budget deficit and associated debt burdens to subnational governments.

Emerging Governance Structure in the 21st Century

While rearrangements taking place in the world today embody diverse features of supranationalization, centralization, provincialization and localization. Nevertheless, the vision of a governance structure that is slowly taking hold is the one that indicates a shift from unitary constitutional structures in majority of the countries to federal or confederal constitutions for a major part of the world. It implies that we are likely to move from a centralized to a globalized and localized world. The role of the central governments in such a world would change from that of a managerial authority to a leadership role in a multi-centred government environment. The culture of governance is also slowly changing from a bureaucratic to a participatory mode of operation; from command and control to accountability for results; from being internally dependent to being competitive and innovative; from being closed and slow to being open and quick; and from that of intolerance from risk to allowing freedom to fail or succeed. Financial crisis around the world are hampering this change and as a result the new vision will take some time to shape in the 21st century (see Table 1) and in many developing countries this vision may not actually materialize due to the conceptual and practical difficulties noted in the following sections.

Table 1: Governance Structure— 20th Versus 21st Century

<i>20th Century</i>	<i>21st Century</i>
♦ Unitary	♦ Federal/confederal
♦ Centralized	♦ Globalized and localized
♦ Center manages	♦ Center leads
♦ Bureaucratic	♦ Participatory
♦ Command and control	♦ Responsive and Accountable
♦ Internally dependent	♦ Competitive
♦ Closed and slow	♦ Open and quick
♦ Intolerance of risk	♦ Freedom to fail/succeed

3. Why the Road to Reform Remains a Field of Dreams in Developing Countries?: Theoretical Considerations

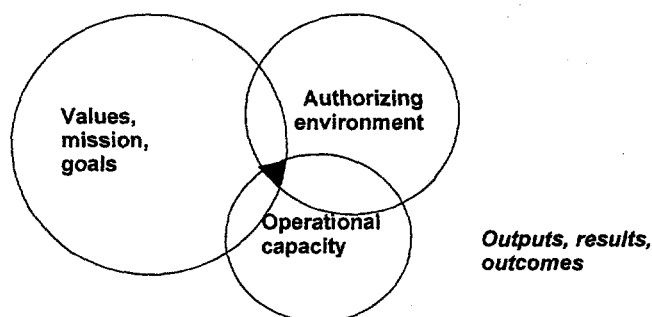
A simple way to see why the public sector is dysfunctional and does not deliver much in developing countries yet is difficult to reform, is to have a closer look at public sector mission and values, its authorizing environment and its operational capacity.

- a) *Public sector mission and values.* Societal values and norms, e.g., as embodied in the constitution or in annual budget policy statements, may be useful points of reference for public sector mandates and the values inherent in these mandates. Unwritten societal norms that are widely shared or acknowledged should also be taken into consideration. In industrialized countries, the mission and values of the public sector are spelled out in terms of a medium term policy framework. For example, there is a formal requirement in New Zealand that a policy statement of this type be tabled in the parliament by March 31 (about 2-3 months in advance of the budget statement). Public sector values in developing countries are rarely addressed. This is because the orientation of the public sector remains towards “command and control” rather than to serve the citizenry. For an official trained in ‘command and control’, the need to develop a code of conduct with a client orientation, may appear frivolous.
- b) *Authorizing environment.* This includes formal (budgetary processes and institutions) and informal institutions of participation and accountability. Do these institutions and processes work as intended in providing an enabling environment for the public sector to meet its goals? Do various levels of government act in the spirit of the constitution in exercising their responsibilities? What are the checks and balances against deviant behavior? Is the independence of the central bank, the judiciary, and the auditor general guaranteed? Is the central bank focused solely on price stability or is it expected to pursue multiple objectives? Are there formal rules to ensure fiscal discipline? Is the design of transfers consistent with their objectives? Are there private agencies that rate various levels of government for their credit worthiness? Is public sector borrowing subject to financial market discipline? How is government performance measured? Are output and outcome indicators for public services monitored by any one? In industrialized countries, institutional norms are strictly adhered to and there are severe moral, legal, voter and market sanctions against non-compliance. In a developing

country environment, non-compliance is often neither monitored nor subject to any sanctions.

- c) *Operational capacity and constraints.* What is authorized is not necessarily what will get done as the available operational capacity may not be consistent with the task at hand. Further, even the operational capacity that is available may be circumvented by the bureaucratic culture or incentives that reward command and control, and corruption and patronage. Some key questions, the answers to which will give a better understanding of operational capacity, include: Do the agencies with responsibility for various tasks have the capacity to undertake them? Do they have the right skills mix as well as the incentive to do the right things and to do them correctly? Is the bureaucratic culture consistent with the attainment of societal objectives? Are there binding contracts on public managers for output performance? Does participation by civil society help alleviate some of these constraints? To what extent can these constraints be overcome by government reorganization and reform? Whereas, in industrial countries, answers to most of the above questions are expected to be in the affirmative, this is not true in the case of a developing country.

Figure 1: Public Sector Institutional Environment
in Developing Countries



The challenge of public sector reform in any country is to harmonize the public sector's mission and values, its authorizing environment and its operational capacity so that there is a close, if not perfect, correspondence among these three aspects of governance (see Figure 1). Such a task is daunting for many developing countries since they often have lofty goals, but lack an authorizing environment that is capable of translating these goals into a policy framework.

This problem is often compounded further by bureaucratic incentives that make any available operational capacity to implement such a framework completely dysfunctional.

Table 2 presents a stylized comparison of the institutional environment in a primitive society, a developing country and an industrialized country. It is interesting to note that while technical capacity in the modern sense was non-existent in a traditional society, due to harmonization of its goals, its authorizing environment and its operational capacity, public sector outcomes were consistent with member preferences. The cultures of such societies more often than not focused on accountability for results. The system of rewards and punishment was credible and swift and much of the business relations were based on informality and trust. Thus while per capita GDP in such societies was quite low, member satisfaction with collective action, the so called "viagara index" was observed to be high and quite possibly not too far behind the degree of satisfaction with public sector experienced in today's industrial societies.

Table 2: Public Sector Institutional Environment—Stylized Facts

	<i>Primitive society</i>	<i>Developing country</i>	<i>Industrial country</i>
Goals	Clear and realistic	Vague and grandiose	Clear and realistic
Authorizing environment	Strong	Weak	strong
Operational capacity	Consistent and functional	Dysfunctional	Consistent and functional
Evaluation capacity	Strong	Weak or extant	Strong
Public sector orientation	Ouput	Input control, command, and control	Input and output monitoring
Public sector decision making	Decentralized	Centralized	Decentralized
Private sector environment	Informality and trust	semi-formality but lack of trust and disregard for rule of law	Formal and legal
Evaluation culture	Snakes and ladders	"Gotcha"	Learning and improving

This contrast with the picture that can be portrayed for a typical developing country. In such a country, there is discordance in the society's goals, authorizing environment and operational capacity. As a consequence of this disharmony, not much gets accomplished and citizens expectations are belied. Lack of accountability and focus of the evaluation culture on frying a big fish occasionally but doing nothing with the systemic malaise means that any self-correcting mechanisms that may exist are blunted. Semi-formality imposes additional costs on doing business but does not lead to any benefits in business relations due to disrespect for law. Contracts may not be honoured and therefore carry little value. In view of this completely

dysfunctional nature of public sector in many developing countries, it is important for these to leapfrog forward (or even backwards) to a public sector culture that puts premium on client orientation and accountability for results. This is however, unlikely to happen soon for reasons to be discussed later.

In the following section, we take a look at some of the factors that are at play in impeding the progress of realignment of functions and harmonization of public sector mission, values, authorization environment and operational capacity in developing countries.

4. Why the Road to Reform Remains a Field of Dreams? Practical Considerations

We noted that fiscal systems in most developing countries require significant restructuring. Progress to date on such reforms have been uneven. A number of factors impede the progress of reform to varying degrees in various countries.

Political Factors

Political ownership is critical to the success of any fiscal rearrangements. In Latin America and former centrally planned economies, emergence of democratic governance and political freedoms led to heightened interest in improvement of public sector performance and decentralization of local public services was seen an important element of this reform. In Latin America, disenchantment with military rule and dictatorships of various persuasions has led to creation of a political culture that places a premium on decentralized decision making to forestall a return to the past. In China, decentralization was seen as a means for social cohesion, faster economic growth and preservation of communist party rule. Politics blocks reform in other countries. In Indonesia, forefathers of the constitution clearly intended it to be a centralized unitary country and dictated against establishment of “states within the state”. These concerns for political unity have dominated the design of institutions. Well entrenched roles of military and civil service in political affairs with a strong belief in command and control from the Center have sustained centralization of responsibility. Appointment of governors and mayors also strengthens centralization and limits local autonomy. In recent years, however, social development and economic prosperity and concerns for improving the delivery of public services are bringing a degree of accommodation for decentralized institutions.

In Pakistan, political instability and feudal interests have contributed to setting aside constitutional dictums and introducing a system of centralized governance. Pakistan has been under military rule for a major part of its existence and military mind set does not accommodate decentralized decision making. During the periods, political activities were permitted, feudal influences dominated the political system and these influences favored either a centralization or provincialization of authority. This is because, while Pakistan has experienced heightened urbanization in recent years with over forty percent of the total population as urbanized, electoral system still recognizes 1981 basis of population distribution (17% urban)². In rural areas of Sind and Balochistan, and to a more limited extent in rural areas of Punjab and NWFP provinces, feudal lords do not allow effective political participation. The use of antiquated basis of population allows feudal lords to dominate politics at the federal and provincial levels. A centralized system allows these lords to have greater effective control than would be possible under a decentralized system where the urban sector would have a more significant voice. To further entrench feudal lords, under the leadership of the former Prime Minister Ms. Bhutto in 1994, local governments were disbanded in all metropolitan areas and not restored even when in 1996 the Supreme Court of Pakistan found this practice to be in contravention of the law. Grants to members of national and provincial legislatures for development projects as practiced until 1997, may have worked against the development of local governments as these members enjoyed a greater degree of autonomy in project execution in the absence of a well functioning system of local government.

Bureaucratic Factors

Many countries in Africa and Asia share a common colonial heritage. The British, Dutch and French colonial systems instituted a system of bureaucratic control to achieve with maximum efficiency colonial objectives of a predatory state. The system created a core of civil service elite which was highly educated and highly dedicated to serving the colonial rulers. Their loyalty to rulers and detachment from the common man was duly rewarded by allowing them preferential access to all public services through elite institutions and by ensuring them financial security through a system of cash rewards and land grants. Thus colonized countries such as

² The population census scheduled for 1991 was finally held in 1998.

India, Kenya, Pakistan and Indonesia inherited civil service regimes that were highly centralized, efficient, accountable, professional and completely detached from local population. These regimes have remained resistant to change. For example, after independence, in Indonesia, civil service over time became an active political partner with military in governing the country. Both partners viewed central control as a key element in holding this country of 14,000 islands together. A centralized regime also was conducive to capturing rents from private sector development. Over time, nevertheless, they discovered that initial degree of centralization was not sustainable and therefore substantial degree of autonomy to local governments while keeping a weak structure of provincial governments, is necessary to improve delivery of local services. A gradual shift towards local control (localization) is thus seen as posing no threat to national unity and to the preservation of a command and control oriented bureaucratic regime.

Similarly in Pakistan, after independence, the civil service retained its “professional” orientation for a while benefiting from an increasing array of perks such as almost costless acquisition of prime real estate, free membership in sports and entertainment complexes financed by public funds, privileged access to elite educational institutions for children etc. Political purges of the civil service in late sixties and early seventies set the civil service on a road to administrative decline (see Haque 1996)³. With insecurity regarding the lack of tenure, areas of public intervention expanded beyond limits and perks and bribes mushroomed. Corruption now enables officials to insure their careers against political risks. Thus the administrative system became highly centralized, entrenched yet dysfunctional. A key feature of this system has a special bearing on local governance. Key positions on provincial (provincial secretary) and district governance (divisional and district commissioners) are held on assignment by officers of the elite “District Management Group”. While performing these duties at subnational levels, they remain primarily accountable to the federal government only. This system negates federalism and re-re-enforces federal control over local decision making. For local governments, an especially worrisome aspect of this system of governance is that if the local governments function well, district commissioner’s powers are considerably curtailed. On the other hand, if the local

³ This point is contested by a reviewer who argued, “ I think the reason for the demise of the civil service are more complicated than portrayed on p.7. In particular, while political interference (and the political purges late sixties and early seventies” as the paper notes) was certainly highly detrimental, some of the changes introduced under Prime Minister Z.A. Bhutto’s 1973 reforms were potentially good ones (e.g. lateral entry) in and of themselves; they foundered in the absence of action to address other systemic issues (e.g. political interference).”

government is not operative, the district commissioner becomes the sole discharged of legislative, judicial and executive functions at the district level. No wonder, one sees that local governments are not allowed to succeed in Pakistan (see Shah, 1996)⁴.

Institutional Factors

Institutional factors also impede effective decentralization. Traditional institutions and mechanism of governance and accountability over time have withered away but these have not been replaced by newer institutions. Instead, all pervasive role of the state have retarded critical look at public policies and institutions. There is almost complete monopoly of the government on institutions of critical thought and media in many countries. Any critical review of government policies and programs invites a government backlash. In Pakistan, rural self government worked well in earlier days of its independence. This system was abandoned in favor of a more centralized system which has resulted in denial of access to basic services by rural population. While lack of institutional capacity was cited as a reason for disbandment of the participatory system, the newer system left a majority of citizens with no voice and participation and no access to basic public services. Indonesia, on the other hand, is now nurturing self-government in rural areas through its village development and poor villages grant programs (see Shah, 1996).

Another important aspect of institutional factors is the citizens' philosophy towards government. Do people generally (politicians, bureaucrats, public employees generally and the public/voter) view the public sector as one where one does service for fair compensation or a position to exploit for personal gain. Various opinion surveys suggest that the prevailing public perception about the public sector especially in South Asia and Africa tend to support the latter view and citizens tend to associate public sector with a predatory role.

Contrary to common misconceptions (see for example, Tendler's characterization of Decentralization and Participation paradigm (D&P)), the success of decentralization policies critically require a strong responsive and accountable government at the national level just as the success of centralized governance critically depends upon responsive, accountable and competent field offices of the central government. This is the least understood "paradox of decentralization

⁴ Local elections were held in 1998.

(rearrangements) ”. This suggests that centralization requires a higher degree of local (field office) institutional capacity and competence and greater sophistication and integrity of public information monitoring, finance, accounts and audit systems than required under a decentralized system. The success of decentralized structures on the other hand critically depends upon the higher level enabling environment and citizen participation and less so on the local institutional capacity and information network as confirmed by the Colombian experience (see Fiszbein, 1995). Local institutional capacity and information networks are no doubt important yet these can be overcome by borrowing such capacity from internal and external sources at least during the earlier phases of decentralization provided a supporting higher level enabling environment prevails.

External Participants

Some external participants may also unwittingly impede development of a decentralized public sector in developing countries. A multitude of factors contribute to this development. First, a centralized system lowers transaction costs for external assistance and enlarges the comfort zone for external participants in terms of monitoring the utilization of their funds for intended purposes. Second, some external participants have concerned themselves with the revenue performance (so called “resource mobilization”) of developing countries. Such concerns may lead to larger centralized bureaucracies that pay little attention to efficient delivery of public services. For example in Pakistan, minor improvements in revenue performance of governments have in the past been accompanied by ever deteriorating quality and quantity of public services⁵. Third, centralized systems are more prone to a lack of internal policy agenda due to a lack of citizen participation and more dependent on external advice on policy reform. Typically this leads to quick policy fixes with little sustained reform. For example, in Pakistan, while the 1956 Constitution stated achievement of universal literacy as a goal for the next decade. Forty years later, there has been little change in literacy rates. In population planning, with US assistance, Pakistan established a goal to reduce population growth rate to 2% by 1975. More than twenty years later, in 1998, growth rate hovers around 2.7%. Similarly public deficit reduction has been an elusive goal for the past several decades. External assistance, contrary to its intentions, may

⁵ This point is not shared by a reviewer who argues that:” Revenue performance has not really improved significantly anyway; so the implication that the government (with support from external actors as implied) sacrificed better service delivery to revenue improvements is not warranted.”

have helped the country avoid facing difficult choices in reducing public sector interventions in marketplace. Availability of generous external assistance might have played a part in motivating the federal government in assuming some provincial responsibilities and the provincial governments in overtaking local government mandates.

5. Making Dreams Come True: Getting Institutions Right

Adherence to federalism principles or “getting prices right” or even “getting the rules of the game right” as discussed earlier is a necessary but not a sufficient conditions for the success of decentralized decision making. Complementary formal and informal institutions are needed to ensure that all players in the game adhere to agreed upon set of ground rules and deviant behavior is properly dealt with. In the following, we discuss selected aspects of this consideration.

Institutions and Processes of Intergovernmental Coordination

Federal countries require both formal and informal institutions of intergovernmental coordination. In some federal countries, areas of potential conflict among different levels of government is minimized through clear separation of national and subnational responsibilities (the so-called layer-cake model of federalism as practiced in Australia, Canada, India and Pakistan) and the two levels interact through meetings of officials and ministers (executive federalism) and in Australia, India and Pakistan through federal unilateralism. Some countries place a greater premium on a common response through shared or joint tasks such as Germany, a federal country and the Republic of South Africa, a pseudo federal country. In these countries, in addition to executive federalism, the upper houses of parliament (Bundesrat and the Council of Provinces) play a key role in intergovernmental coordination. In countries with overlapping responsibilities (the so-called marble cake model of federalism), such as United States and Brazil, state lobby of Congress and interstate relations serve coordinating roles. In China, where growth concerns have imposed a federalism structure on a unitary country, regional communist party bosses/ governors exercise a moderating influence on otherwise monolithic orientation of the State Council.

Constitutional provisions per se can also provide coordinating influences. For example, in some federal countries, constitutional provisions require that all legislation recognize that ultimate power rests with the people. For example, all legislation in Canada must conform to the Canadian

Charter of Rights. In Switzerland, a confederation by law but a federal country in practice, major legislative changes require approval by referenda. In Switzerland, there is also a strong tradition of coordination through consensus initiatives by cantons.

Institutional Arrangements for Fiscal Relations

The structure of intergovernmental fiscal relations, especially the system of grants, must be determined by some body. There are five main alternatives. The first is for the federal government alone to decide on it. This alternative negates federalism and would not be acceptable in many countries. The second is to set up a quasi-independent body, such as a grants commission, whose purpose is to design and reform the system as practiced in Australia, India and the Republic of South Africa. This alternative is prone to more ideal solutions rather than pragmatic approaches and therefore runs the risk of presenting complex solutions and recommendations that may not be politically palatable. The third alternative is to use federal-state committees to negotiate the terms of the system as done in Canada. The fourth alternative is to have a joint intergovernmental cum interlegislative commission such as the Finance Commission in Pakistan and the fifth alternative is to have an intergovernmental legislative body such as the upper house of the German Parliament (Bundesrat) as in Germany. The latter three systems allow for explicit political inputs from the jurisdictions involved, and therefore likely to opt for simple and feasible but less than ideal (compromise) solutions.

Institutions of Accountability

Institutions of accountability is the key to the success of decentralized decision making. This entails institutions and mechanisms for citizens voice and exit, norms and networks of civic engagement ("social capital" according to Putnam, 1994), social consensus (Williamson, 1994 and Weingast, 1993), preservation instinct of a "stationary bandit" who monopolizes and rationalizes theft in the form of taxes (Olson, 1993), judicial accountability, vertical and horizontal accountability. The citizen voice and exit require institutions of democratic participation, and accountability provisions for elected officials. The origins and success of decentralization programs in Latin America is traceable to the democratic traditions that emerged in the continent in late 1980s. In Philippines, recently enacted local government legislation while empowering these governments have provided for regular elections and recall of elected officials for a breach of public trust (see the

Republic of Philippines Act No. 7160, the Local Government Code, 1991). While norms and networks of civic engagement were reasonably well developed in pre-colonial traditionalist societies found in many developing countries such as the Panchayat Raj in Pre-British India, these institutions withered away either under the colonial rule or subsequently under centralized bureaucratic governance structures. The net result has been rise of opportunism and social distrust culminating in dysfunctional societies when formal institutions of governance failed. The African and the South Asian development fiascos share this common underpinning. Societal consensus on economic and political rights is also conducive to accountability at all levels. According to Weingast (1993), this consensus need not take any formal expression but would work so long as a majority of people share a common belief as to the limits of governmental intervention and are willing to police those limits by withdrawing their support from a government that fails to abide by them (see Weingast, 1993, p.306). Preservation instincts of a stationary bandit also respect accountability (see Olson, 1993). This is because, the stationary bandit strengthens his grip on power, so long as economic performance is strong and citizens see their well being improved. This explains partly the success of the Asian Tigers and the failure of some South/Southeast Asian regimes. The latter regimes were controlled by “roving bandits” whose main aim was to make the loot to pad their Swiss bank accounts and then disappear in a foreign haven.

Judicial accountability strengthens the credibility of public commitments. This is particularly important for transition economies, where framework laws on property rights, corporate legal ownership and control, bankruptcy, and financial accounting and control are not fully developed. Interestingly enough, judicial accountability is much more difficult to enforce in a parliamentary democracy than in a democratic system which respects separation of legislative and executive functions. This is because, under a parliamentary democracy, the executive branch can override judicial accountability by amending the legislation - a game played ad infinitum in Pakistan to undermine a decentralized federal constitution. Judicial accountability is further compromised under a British style civil service organization as in India and Pakistan where divisional and district commissioners hold simultaneously executive, legislative and judicial powers. As noted by Montesquieu (1970), such a situation is ripe for the abuse of powers as “... When the legislative and executive powers are united in the same body of magistrates, there can be no liberty;... Again, there is no liberty, if the judiciary power be not separated from the legislative and executive” (Montesquieu, 1970, p.397).

We noted earlier that there is a broad consensus on principles that should guide the division of powers and partnerships among different governmental and non-governmental agents (see also Tables 1-3). How to adapt these principles to the existing institutional and cultural context to improve public sector performance should be an ongoing concern. Such improvements will automatically evolve over time and would obviate the need for major painful realignments if learning by doing, evaluation and accountability for results is embedded in the public sector organizational culture. Such a cultural change can be induced by building institutional capacity for evaluation. Such a capacity is vital for citizen participation and higher level oversight - the two important ingredients for the success of any decentralization program. To build such a capacity, it is important to adopt a simple and reasonably objective evaluation methodology and then have mechanisms in place for self, higher level and independent evaluation. Independent evaluations of government programs may be encouraged by formal institutions such as fiscal commissions or associations of local governments as in South Africa, by think tanks, press and the informal sector. The evaluation methodology adopted by the Operations Evaluation Department of the World Bank provides a good starting point for such evaluation. In determining, how well a program is performing, it asks three sets of simple yet powerful questions as follows:

(a) Is the public manager doing the right things?

Relevance: Are the objectives he/she seeks responsive to the needs of the community, he is expected to serve?

Institutional Development: Is the initiative he/she is undertaking will result in improvements in local capacity to do things better in future?

(b) Is the public manager doing things right?

Efficacy: Are the programs achieving agreed upon objectives?

Efficiency: Is he/she using resources economically by forging appropriate partnership within and without the public sector?

(c) Will the benefits of interventions be sustained?

By linking evaluation to performance incentives and budgeting, a culture of responsive and accountable governance can be nurtured. Thus building institutional capacity for evaluation should rank high on the list of priorities for those interested in creating governments that work and strive for excellence in serving their citizens.

It should be noted that inspite of the benefits associated with building evaluation capacity, attention to development of such capacity is unlikely to materialize without changes in the existing incentive structures. Rationalization of fiscal transfers to include conditionality on standards of services and access to such services will provide positive stimulus for evaluation at all levels. Citizen education as to their rights and obligations and the role of public sector and developing independent institutions of critical thought will strengthen demand for such evaluations. Horizontal information exchanges say through voluntary associations of local governments would also serve to enhance demand for evaluations and municipalities would be interested in learning from experiences of member municipalities.

The audit, inspection and control functions should be strengthened, since they tend to be quite weak in transition and developing economies. The auditor-general should be given greater authority and autonomy in exercising his mandate. At the same time, a case can be made for loosening the constraints of the central planning process in developing countries. Central plans lead to a centralization of authority, a reduction in flexibility, innovation and autonomy at the local level and delays in private sector activity. On a more specific point, as fiscal responsibility is decentralized to the state and local levels, it would be beneficial to create the institutional capacity for local borrowing so that more reliance is placed on borrowing and less on capital grants to finance capital projects. Examples include loan councils or municipal finance corporations.

Oversight of Local Governments: Freedom and Responsibility within Boundaries

Monitoring and oversight of local governments is an area of concern in both federal and unitary countries alike. For example, the Republic of South Africa Constitution Act 1996 (Section 139(1) (b)) provides for a disbandment of local government in the event of failure to (i) “maintain national standards or meet minimum standards of service”; (ii) “prevent actions prejudicial to the interests of another municipality or the nation as a whole”; and (iii) “maintain economic unity.” It further provides for withholding of tax shares and transfers for non-compliance with tax effort (Section 227(2)). The fulfillment of constitutional obligations regarding these provisions require a significant and superior evaluation capacity at provincial and national levels. Evaluative measures that can assist in this oversight include requirement of annual commercial corporate audit of local governments; fiscal capacity measurement using a common yardstick i.e. equalization of municipal assessments; greater emphasis on formula grants over project grants in provincial-local transfers; greater emphasis on public-private-civil society partnership in public provision; opinion polls on service standards and citizen satisfaction; and performance ratings of local governments based upon outputs, outcomes and citizen satisfaction.

Audit of local governments in industrialized countries at the most fundamental level pays attention to three elements, adherence to the principle of ultra vires, the procedure by-law and fulfillment of funded mandates. The principle of ultra vires states that a local government should do only those things that the statutes say it can do and it may not do anything for which it has no

express authority. The procedure by-law requires that all policies of local council should be embodied in by-laws and an auditor should look at the council operations for its conformity with policies and beyond the system of internal control. Thus a local government audit would involve the following:

Revenues: by-laws for tax collection and administration; established procedures for assessments, appeals; budget reports incorporating all revenues, financial reports with necessary information; observance of legal requirements of statutes.

Expenditures: By-law for policies, established procedure for purchasing, tendering, payments, inventories etc.; establishment of expenditure limits; financial regulations; observance of statutes.

Others: legal requirements for borrowing; insurance coverage; unfunded mandates; debt; deficit; long term budget; commitments; contingent commitments; cost controls; resource use; staffing.

Services: quality and quantity and distribution.

6. Decentralization - Fine in Theory But What Is the Practice?

Some writers have cautioned against a shift in division of powers in favor of subnational governments in a developing country environment and have highlighted the “dangers of decentralization” (Prud’homme, 1995, also see Tanzi, 1996). These authors have expressed concerns ranging from macro mismanagement, corruption, red tape, and widening gulf between rich and poor persons regions under decentralized fiscal system. Sewell (1996) and McLure (1995) provide rejoinders to these concerns by marshaling conceptual arguments and anecdotal evidence in support of their viewpoints. Others (see Tendler, 1997) have argued that much of the fruits of decentralization can be better achieved by delegation (local government acts on behalf of the higher level government) or deconcentration (regional offices or autonomous agencies of the higher level governments are the implementing agencies) by enlightened central and state governments with strong mistrust of local governments. Such options invite less political and bureaucratic resistance and may not be inferior to decentralization options in terms of their outcome. They argue that healthy antagonism between different levels of government and strong activism by central and state governments improves performance of the public and other support agencies.

In the following, we reflect upon various elements of the “dangers of decentralization” based upon available empirical evidence. In doing so, we primarily focus on the quality of institutional environment for governance rather than the policies themselves. In relating decentralization to quality of institutional environment for governance, four aspects of governance quality are stressed: citizen participation, social development, government orientation and economic management. These aspects are considered in turn in the following paragraphs.

Citizens Participation

Citizen participation ensures that public goods are consistent with voter preferences and public sector accountability. Such participation is possible only if political freedom (voice and exit) is permitted and political stability prevails. Decentralization strengthens citizen participation by bringing governments closer to the people they are intended to serve. The USAID assistance programs has given due recognition to this principle by making decentralization and democratic governance a cornerstone of their policy to develop transparent and accountable government institutions (see USAID, 1997). The success of decentralization as a tool for citizen participation, however, critically depends upon a class-less society and the strength of local government institutions (see also Heymans, 1996). In a feudal structure such as the one prevalent in rural Sindh province of Pakistan, economic dependency of a landless tenant on the feudal lord is so strong that feasible choices as to voting with feet or by ballot do not exist. Under such circumstances, decentralized institutions become captive to the whims of the local elite. In urban areas of Pakistan, where such economic dependency does not exist, the success of decentralization is curtailed by lack of sufficient powers and resources and accountability mechanisms at the local level. Feudal politics and bureaucratic institutions consider implementation of legal provisions on devolution as a threat to their interests and render any such provisions ineffective. In spite of these difficulties, the record of decentralized fiscal systems in promoting citizen participation is quite impressive as shown by Huther and Shah (1998) using data for a sample of 80 countries. They find that political stability and political freedom indices and a composite index on citizen participation are positively correlated with the index of fiscal decentralization. This relationship is statistically significant which suggests that citizen participation and public sector accountability go hand in hand with decentralized public sector decision making.

James Manor based upon his work in India and Africa concludes considerable promise for decentralization in promoting citizen participation, increasing information flows between governments and citizens, enhancing transparency and accountability, integrating society with the state and reinforcing and invigorating democracy at the national level (see Manor, 1996). Recognizing this, India has recently amended its constitution to strengthen local government institutions (see Paul, 1996). The same results are reaffirmed by Garman and Haggard (1995) based upon a comparative study of Latin America. They conclude that “greater the political sensitivity of central level politicians to subnational political outcomes, the more decentralized the system is likely to be “ (p.2).

Table 3: Correlation of the Decentralization Index with Governance Quality Indicators
(sample size: 80 countries)

	<i>Pearson Correlation Coefficients</i>
<i>Citizen Participation</i>	
Political Freedom	0.599**
Political Stability	0.604**
<i>Government Orientation</i>	
Judicial Efficiency	0.544**
Bureaucratic Efficiency	0.540**
Absence of Corruption	0.532**
<i>Social Development</i>	
Human Development Index	0.369*
<i>Egalitarianism in Income</i>	0.373*
<i>Distribution</i>	
<i>(inverse of Gini coefficient)</i>	
<i>Economic Management</i>	
Central Bank Independence	0.327*
Debt Management Discipline	0.263
<i>(Inverse of Debt to GDP Ratio)</i>	
Openness of the Economy (Outward Orientation)	0.523**
<i>Governance Quality Index</i>	0.617**

* significant at the 0.05% level (2-tailed test)

** significant at the 0.01% level (2-tailed test)

Source: Huther and Shah (1998)

Public sector orientation plays an important role in public sector performance. If the public service is oriented towards serving its citizens, bureaucratic red tape and corruption would be minimal and judiciary will further enforce accountability through timely and fair decisions in the administration of justice. One finds such an orientation typically lacking in some developing countries where the civil service pursues rent seeking and power and influence through command and control and bureaucratic red tape and graft.

A composite ranking of countries of three indicators of government orientation, judicial efficiency, bureaucratic efficiency, and the lack of corruption, provides a good indicator of public sector orientation and performance. We relate the degree of expenditure decentralization to the ranking of countries on individual indicators as well as to the composite rank on government orientation and find that all of these correlations show a positive, and statistically significant, association (see Table 3). This suggests that typically decentralized countries are more responsive to citizen preferences in service delivery and strive harder to serve their people than centralized countries.

Several case studies corroborate above findings. Crook and Manor (1994), Meenakshisundaram (1996) based upon a review of experience of the Indian state of Karnataka, and Blair (1996) based upon Philippines' more recent experience with decentralization, conclude that decentralized democratic governance had a positive impact on the quality of governance especially in re-orienting government from a command and control to a service provider role (see also Blair and Hansen, 1994). Landon (1996) carried out a study of education costs in Canada and concluded that local control regimes were more successful in controlling overhead costs than provincial control regimes. Teacher salaries, on the other hand, were better controlled by provincial systems. Humplick and Moini-Araghi (1996) report that for a large sample of countries decentralization leads to lower unit administration costs for road services.

Social Development

Two aspects of social development are considered: human development and income inequality. For ranking countries in terms of their achievements on human development, we solely rely on the United Nations' index on human development. This index incorporates life expectancy, adult literacy, educational enrollments and per capita GDP in purchasing power parity terms. Egalitarian nature of the society is captured by an inverse rank on the Gini coefficients estimated by Deininger and Squire (1996). Table 3 shows that fiscal decentralization is positively correlated and statistically significant with both the indices.

Institutional Environment for Macroeconomic Management

It is frequently argued that a decentralized public policy environment of the type found in developing countries contributes "to the aggravation of macroeconomic problems" (Tanzi, 1996, p.305). In the following, we reflect upon the available empirical evidence on aspects of institutional framework for monetary and fiscal policies to form a perspective on this issue.

Institutional Setting for Monetary Policy

Monetary policy is clearly a central function and best entrusted to an independent central bank (Shah, 1994, p.11). The critical question then is whether or not independence of central bank is compromised under a decentralized fiscal system. One would expect, a priori, that the central bank would have greater independence under a decentralized system since such a system would require clarification of rules under which a central bank operates, its functions and its relationships with various governments. For example, when Brazil in 1988 introduced a decentralized federal constitution, it significantly enhanced the independence of the central bank (Bomfim and Shah, 1994). On the other hand, in centralized countries the role of the central bank is typically shaped and influenced by the Ministry of Finance. In an extreme case, the functions of the central bank of the U.K., the Bank of England, are not defined by law but have developed over time by a tradition fostered by the U.K. Treasury.

For a systematic examination of this question, we relate the evidence presented in Cukierman, Webb and Neyapti (1992) on central bank independence for 80 countries to indices

of fiscal decentralization for the same. The correlation coefficient in Table 3 shows a weak but positive association confirming our a priori judgment that central bank independence is strengthened under decentralized systems. Increases in monetary base caused by the Central Bank's bailout of failing state and non-state Banks represents an important source of monetary stability and a significant obstacle to macro economic management. In Pakistan, a centralized federation, both the central and provincial governments have, in the past, raided nationalized banks. In Brazil, a decentralized federation, state banks have made loans to their own governments without due regard for their profitability and risks causing the so called \$90 billion state debt crisis in 1995. Thus a central bank role in ensuring arms length transactions between governments and the banking sector would enhance monetary stability regardless of the degree of centralization.

Available empirical evidence suggests that such arm length transactions are more difficult to achieve in countries with a centralized structure of governance than under decentralized structure with a larger set of players. This is because a decentralized structure requires greater clarity in the roles of various public players, including the central bank. No wonder one finds that the top three most widely acknowledged independent central banks (Swiss Central Bank, Bundes Bank of Germany and the United States Federal Reserve Board) have all been the products of highly decentralized fiscal structures.

Fiscal Policy

In a centralized country, central government assumes the exclusive responsibility for fiscal policy. In decentralized countries, fiscal policy becomes a responsibility shared by all levels of government and the federal (central) government in these countries use their powers of the purse (transfers) and moral suasion through joint meetings to induce a coordinated approach. Several writers (Tanzi, 1995, Wonnacott, 1972) have argued, without empirical corroboration, that the financing of subnational governments is likely to be a source of concern within open federal systems since subnational governments may circumvent federal fiscal policy objectives. Tanzi (1995) is also concerned with deficit creation and debt management policies of junior governments. Available theoretical and empirical work does not provide support for the validity of these concerns. On the first point, at a theoretical level, Sheikh and Winer (1977) demonstrate that relatively extreme and unrealistic assumptions about discretionary non-cooperation by junior

jurisdictions are needed to conclude that stabilization by the central authorities would not work at all simply because of this lack of cooperation. These untenable assumptions include regionally symmetric shocks, closed economy, segmented capital markets, lack of supply side-effects of local fiscal policy, non-availability of built-in stabilizers in the tax-transfer systems at subnational levels and in interregional trade, unconstrained and undisciplined local borrowing and extremely non-cooperative collusive behavior by subnational governments (see Spahn, 1997) . Their empirical simulations for Canada further suggest that failure of a federal fiscal policy in most instances cannot be attributed to non-cooperative junior governments' behavior. Saknini, James and Sheikh (1996) further demonstrate that, in a decentralized federation with markedly differentiated subnational economies with incomplete markets and non-traded goods, federal fiscal policy acts as an insurance against region-specific risks and therefore decentralized fiscal structures do not compromise any of the goals sought under a centralized fiscal policy.

On the potential for fiscal mismanagement with decentralization as noted above by Tanzi, empirical evidence from a number of countries suggests that, while national/central/federal fiscal policies typically do not adhere to the European Union (EU) guidelines that deficits should not exceed 3% of GDP and debt should not exceed 60% of GDP, junior governments policies typically do. This is true both in decentralized federal countries such as Canada and centralized federal countries such as India and Pakistan. Centralized unitary countries even do worse on these indicators. For example, Greece, Turkey and Portugal do not satisfy the EU guidelines. It is also interesting to note that fiscal stabilization failed under centralized structures in Brazil and Argentina but the same countries achieved major successes in this arena later under decentralized fiscal systems. The results in Table 3 provide further confirmation of these observations.

Subnational Borrowing

Capital finance needs of developing and transition countries are currently estimated at about \$100 billion a year. Most of these investment needs are for local public infrastructure. Water and sewerage projects account for one-half of these investment needs. Local governments typically command a lion's share in public sector investments with a low of 30% in developing countries and 70% in industrialized countries. Therefore, subnational credit market access represents a major challenge to finance development needs. In a decentralized fiscal environment, this challenges poses significant risks for macro stabilization policies of the national government

as its options for credit rationing and direct controls are significantly constrained by constitutional division of powers. Instead decentralized fiscal systems rely upon a combination of credit market discipline, moral suasion and agreed upon rules to impose financial discipline on local governments. Which system works better is an empirical question worthy of rigorous research. The available evidence nevertheless point to superior performance of decentralized systems in restraining subnational debt. Central controls as imposed in France, Spain, U.K. , India, Pakistan and Australia (till 1992 under the old Australian Loan Council) failed to keep subnational debt in check as intergovernmental gaming led to weaker discipline and the possibility of central bailout encouraged less rigorous scrutiny by the financial sector (see Shah, 1997 for details). Decentralized federations on the other hand, rely on a combination of guidelines, intergovernmental cooperation and market discipline to keep subnational debt within sustainable limits. They typically adopt a "golden rule" guideline by which subnational borrowing is constrained for capital projects only or for short term purposes to smooth out revenue inflows and outflows within a single fiscal period. This is the practice in Canada, USA, Germany and Switzerland. European Union has imposed guidelines on deficit and debt limits as discussed earlier and has prohibited central banks from bailing out any governments. Intergovernmental cooperation or moral suasion is achieved through executive federalism as in Canada or multilateral information exchange through the New Australian Loan Council as in Australia or through bilateral negotiations as in Denmark. Most importantly the cornerstone of financial discipline under a decentralized fiscal system is the market discipline enhanced by an enabling public policy environment that stresses central bank independence, disengagement of governments from ownership of commercial banks, no bailouts by the central bank or by a higher level government and requirements for public dissemination of information on public finances. Some countries such as Switzerland require further that all public borrowing should be subject to popular referenda. State debt crisis in Brazil should not come as a surprise to an informed observer as Brazil opted for a decentralized fiscal constitution but failed to adopt appropriate policies to ensure market discipline in such environment as it allowed states to own commercial banks and borrow from these in a relatively unconstrained fashion while holding open the possibility of central government bailout in the event of default. Only recently Brazil has moved to create an enabling framework for credit market discipline for subnational borrowing (see also Ter-Minasian, 1996). Recent initiatives to control state/local debt include: sale or rigid controls over state owned bank; privatization of utilities; downsizing; and restructuring and harmonization

of the state value added tax (ICMS) to limit its potential for state industrial policy (see Afonso and Lobo, 1996).

Outward Orientation

Economic liberalization is now commonly accepted as a cornerstone of good economic management. World Bank has recently ranked countries on the openness of their economies taking into account factors such as GNP originating from trade, manufacturing exports, foreign direct investment as a share of GDP, commercial credit rating and manufacturing content of exports. This index of economic liberalization is positively related to the index of fiscal decentralization.

Institutional Environment for Economic Management

Huther and Shah (1998) combine the three aspects of economic management considered above in a quality index of economic management, the resulting index shows a positive association with the degree of fiscal decentralization. This is to be expected as the decentralized systems are more transparent in defining the role of various public agents and place a greater premium on accountability for results.

Quality of Governance and Decentralization

Huther and Shah (1998) further combine indices on institutional environment for economic management, social development, government orientation and citizen participation to derive an overall index of governance quality. This index is then related to the degree of fiscal decentralization. Given the positive correlation between all of the governance quality component indices and the composition of government expenditures, the positive relationship between fiscal decentralization and governance quality is to be expected yet it is surprising to discover the strength of this positive association (as indicated by correlation coefficient of 0.62) and further that about 38% of the variance in governance quality is explained by fiscal decentralization alone.

Decentralization and Regional Equity

While we have not addressed the regional equity issue due to paucity of data, a few casual observations may be in order. As we noted earlier, regional inequity is an area of concern for decentralized fiscal systems and most such systems attempt to deal with it through the spending powers of the national government or through fraternal programs. Mature federations such as Australia, Canada and Germany have formal equalization programs. This important feature of decentralization has not received adequate attention in the design of institutions in developing countries. Despite serious horizontal fiscal imbalances in a large number of developing countries, explicit equalization programs are untried, although equalization objectives are implicitly attempted in the general revenue sharing mechanisms used in Brazil, Colombia, India, Mexico, Nigeria and Pakistan. These mechanisms typically combine diverse and conflicting objectives into the same formula and fall significantly short on individual objectives. Because these formulas lack explicit equalization standards, they fail to address regional equity objectives satisfactorily.

Regional inequity concerns are more easily addressed by unitary countries but it is interesting to note that the record of unitary countries in addressing these inequities is uneven and certainly no better than federal countries (For evidence on regional income inequalities, Canada: Shah (1996), China, Tsui (1996), Indonesia (Shah and Others, 1994), Brazil (Shah, 1991), Pakistan (Shah, 1995), India (Rao, 1996)).

Decentralization and the Size of the Government

The public choice literature in an extreme version, has portrayed the government as a monolithic entity, “Leviathan” that acts purely in its own interest relatively unconstrained by the voters. It is usually thought to be interested in maximizing its own size. To the extent that this is true, it will have consequences for the assignment of powers in the sense that greater decentralization may reduce the ability of governments to increase their size wastefully. This is because both “voting with feet” and “voting by ballot” constrain the bureaucratic and political temptations for empire building. Ehdaie (1994) provides empirical support for this proposition. He concludes that simultaneous decentralization of the national government’s taxing and spending powers, by directly linking the costs and benefits of public provision, tends to reduce the size of the public sector. Expenditure decentralization accompanied by revenue sharing delinks responsibility and accountability and thereby fails to achieve this result.

7. Some Lessons for Developing Countries

The following important lessons for reform of fiscal systems in developing countries can be distilled from a review of past experiences.

Enabling Environment for Decentralization i.e. Institutions of Citizen Participation and Accountability Must be Addressed in Any Serious Reform of Fiscal Systems. Even in primitive societies such as pre-British India, systems of local governance worked effectively to deliver local services and collect local charges due to well understood mechanisms of citizen participation and accountability. More modern systems of local governance such as those run by elite Pakistani bureaucrats with training in management including financial management have failed due to a lack of citizen voice and accountability checks. The reform effort must embody appropriate provisions of recall of elected officials for negligence or misconduct. Fostering institutions of critical thought and evaluation, independence of judiciary and a free media can play an important part in political and bureaucratic accountability. These elements have not been sufficiently addressed in most reform efforts.

Societal norms and consensus on roles of various levels of governments and limits to their authorities are vital for the success of decentralized decision making. In the absence of such norms and consensus, intergovernmental gaming leads to dysfunctional constitutions.

Civil Service Reform is Critical to the Success of a Decentralization Program. Bureaucratic ownership of a reform program is critical but such ownership would not be forthcoming in most developing countries where decentralization is seen as an attempt to weaken the powers of central bureaucracy. To overcome this, the reform of fiscal systems must embody reform of central bureaucracies. Such a reform must ensure that the Center has no direct say in the recruitment and promotions of civil servants, other than overseeing that standards of transparency and fairness are met, at the subnational levels and that remunerations of subnational services must be competitive with the central government. Further, civil service incentive structure should reward service orientation and performance and discourage command and control and rent seeking. This can be accomplished through performance contracts, stay with it culture, recognition of specialized skills and evaluation systems that link performance, rewards and budgeting.

Evaluation capacity development is of fundamental importance in public sector reform in developing countries. Formal ex-post evaluation nurtures a climate of listening, learning and accountability in the public sector. This is of greater importance in the context of developing countries where “government failures” have been spectacular but resulted in little afterthought on appropriateness of development objectives and strategies as institutions for accountability are weak or non-existent. In such an environment, evaluation can nurture a “bottom-line” or “development effectiveness culture” as Picciotto (1993) has argued that “evaluation is to the public sector what accounting is to the private sector”. It is interesting to note that the 1996 Constitution of the Republic of South Africa has imposed stringent monitoring and evaluation requirements on higher level governments to ensure proper monitoring and oversight of local governments.

Traditional administrative capacity matters but should not be considered as an impediment to decentralization. Administrative capacity to develop and maintain modern organizational practices such as budgeting, auditing and accounting systems is no doubt important but should not be considered as a barrier to decentralization provided citizen participation and transparency in decision making is ensured. This is because technical capacity can be borrowed from supportive higher level governments and elsewhere

Asymmetric Decentralization as provided under the Indonesian Decentralization Program and Under Provincial Local Government Ordinances in Pakistan offers a thoughtful approach to Decentralization. Regardless of the availability of help from higher level governments, lack of institutional capacity should never be considered as an excuse not to decentralize. Instead, an objective program of decentralization which recognizes the nature and type of local government, its clientele and its fiscal capacity can be developed and various local governments can be assigned differential powers by taking into account the above mentioned factors as was done in Pakistan in the past and more systematically being done in Indonesia by rating each local government.

A major separation of spending and taxing decisions leads to lack of accountability in the public sector. In Mexico, South Africa and Pakistan, federal revenue sharing transfers finance up to 99% of expenditures in some provinces. This delinking of taxing and spending responsibilities

have led to accountability problems at the provincial levels. In the event of such de-linking, role of conditional (conditional on standards of services and access to such services and not on expenditures) block transfers and evaluation is worth examining to enhance accountability.

Sharing of revenues on a tax by tax basis distorts incentives for efficient tax collection. In Pakistan in the past (until 1996), tax by tax sharing of income and sales taxes may have impeded reform of trade taxes which were not shared with the provinces.

Successful decentralization cannot be achieved in the absence of a well designed fiscal transfers program. The design of these transfers must be simple, transparent and consistent with their objectives (see Appendix Table 3) . Properly structured transfers can enhance accountability of the fiscal system just as general revenue sharing has the potential to undermine it. Experiences of Indonesia and Pakistan offer important insights in grant design. For example, Indonesia's education and health grants use simple and objectively quantifiable indicators in allocation of funds and conditions for the continued eligibility of these grants emphasize objective standards as to access to these services. Indonesian grants for public sector wages on the other hand, represents an example of not so thoughtful design as it introduces incentives for higher public employment at subnational levels. Pakistan's closed-end matching grant for resource mobilization, similarly rewards relatively richer provinces more for additional tax effort. An open-ended precursor of this grant program in vogue during 1991-1996 also called into question the credibility of federal commitment as the federal government was not able to meet its commitment arising from that grant program.

The role of fiscal transfers in enhancing competition for the supply of public goods should not be overlooked. For example, transfers for basic health and primary education could be made available to both public and not-for-profit private sector on equal basis using as criteria, the demographics of the population served, school age population and student enrollments etc. This would promote competition and innovation as both public and private institutions would compete for public funding. Chile permits Catholic schools access to public education financing. Canadian provinces allows individual residents to choose among public and private schools for the receipt of their property tax dollars. Such an option has introduced strong incentives for public and private schools to improve their performances and be competitive. Such financing options are especially attractive for providing greater access to public services in rural areas.

Finally, contrary to a common misconception, a developing country institutional environment calls for a greater degree of decentralization than needed for an industrialized country. For an efficient working of a centralized bureaucracy, advanced information gathering and transmittal networks, an efficient and dedicated civil service, and well developed institutions of citizen participation and accountability are needed. This is possible in the setting of an industrialized country environment. A more primitive public sector environment is more suited to a decentralized form of governance. This is because information requirements and transaction costs are minimized by moving the decision making closer to people who are affected by those decisions. Closeness also serves to enhance better participation, preference matching for public services, transparency and greater accountability.

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Annex Table 1 . A Representative Assignment of Expenditure Responsibilities

<i>Function</i>	<i>Policy, standards & oversight</i>	<i>Provision/ administration</i>	<i>Production/ Distribution</i>	<i>Comments</i>
Interregional & International conflicts resolution	U	U	N,P	Benefits & costs international in scope
External trade	U	U,N,S	P	" "
Telecommunications	U, N	P	P	National regulation not feasible
Financial Transactions	U,N	P	P	" "
Environment	U,N,S,L	U,N,S,L	N,S,L,P	Externalities of global, national, state and local scope.
Foreign Direct Investment	N,L	L	P	local infrastructure is critical
Defense	N	N	N,P	Benefits & costs national in scope
Foreign Affairs	N	N	N	" "
Monetary policy, currency, banking	U, ICB	ICB	ICB, P	Independence from all levels essential. Some international role for common discipline
Interstate commerce	Constitution, N	N	P	Constitutional safeguards important for factors and goods mobility
Immigration	U,N	N	N	U due to forced exit
Transfer payments	N	N	N	Redistribution
Criminal and civil law	N	N	N	Rule of law , a national concern
Industrial policy	N	N	P	To avoid beggar-thy neighbour policies
Regulation	N	N,S,L	N,S,L,P	Internal common market
Fiscal Policy	N	N,S,L	N,S,L,P	Coordination is possible
Natural Resources	N	N,S,L	N,S,L,P	Promotes regional equity and internal common market
Education, Health & Social Welfare	N,S,L	S,L	S,L,P	Transfers in kind
Highways	N,S,L	N,S,L	S,L,P	Benefits and costs of various roads vary in scope.
Parks & Recreation	N,S,L	N,S,L	N,S,L,P	" " "
Police	S, L	S,L	S,L	Primarily local benefits
Water, sewer, refuse, fire protection	L	L	L,P	" " "

Note: U is supranational responsibility, ICB is independent central bank, N is national government, S is state/provincial government, L is local Government and P is non-government sectors/civil society.

Annex Table 2: Conceptual basis of tax assignment

<i>Types of Tax</i>	<i>Determination of Base</i>	<i>Collection and Rate</i>	<i>Administration</i>	<i>Comments</i>
Customs	F	F	F	International trade taxes.
Corporate income	F, U	F,U	F,U	Mobile factor, stabilization tool.
Resource taxes				
Resource rent (profits/income) tax	F	F	F	Highly unequally distributed tax bases.
Royalties, fees, charges; severance taxes; production, output, and property taxes	S,L	S,L	S,L	Benefit taxes/charges for state-local services.
Conservation charges	S,L	S,L	S,L	To preserve local environment.
Personal income	F	F,S,L	F	Redistributive, mobile factor, stabilization tool.
Wealth taxes (taxes on capital, wealth, wealth transfers, inheritances, and bequests)	F	F,S	F	Redistributive.
Payroll	F,S	F,S	F,S	Benefit charge, e.g., social security coverage.
Multi-stage sales taxes (value-added tax, [VAT])	F	F	F	Border tax adjustments possible under federal assignment; potential stabilization tool.
Single stage sales taxes (manufacturer/wholesale/retail)				
Option A	S	S,L	S,L	Higher compliance cost.
Option B	F	S	F	Harmonized, lower compliance cost.
"Sin" taxes				
Excises on alcohol and tobacco	F,S	F,S	F,S	Health care a shared responsibility.
Betting, gambling	S,L	S,L	S,L	State and local responsibility.
Lotteries	S,L	S,L	S,L	State and local responsibility.
Race tracks	S,L	S,L	S,L	State and local responsibility.
Taxation of "Bads"				
Carbon	F	F	F	To combat global/national pollution.
BTU taxes	F,S,L	F,S,L	F,S,L	Pollution impact may be national, regional, or local.
Motor fuels	F,S,L	F,S,L	F,S,L	Tolls on federal/provincial/local roads.
Effluent charges	F,S,L	F,S,L	F,S,L	To deal with interstate, intermunicipal or local pollution issues.
Congestion tolls	F,S,L	F,S,L	F,S,L	Tolls on federal/provincial/local roads.
Parking fees	L	L	L	To control local congestion.
Motor vehicles				
Registration, transfer taxes, and annual fees	S	S	S	State responsibility.
Driver's licenses and fees	S	S	S	State responsibility.
Business taxes	S	S	S	Benefit tax.
Excises	S,L	S,L	S,L	Residence-based taxes.
Property	S	L	L	Completely immobile factor, benefit tax.
Land	S	L	L	Completely immobile factor, benefit tax.
Frontage, betterment	S,L	L	L	Cost recovery.
Poll	F,S,L	F,S,L	F,S,L	Payment for local services.
User charges	F,S,L	F,S,L	F,S,L	Payment for services received.

Note: U is supranational agency, F is federal, S is state or province, L is municipal or local.

Source: Shah (1994).

Annex Table 3. Principles and Better Practices in Grant Design

<i>Grant Objective</i>	<i>Grant Design</i>	<i>Better Practices</i>	<i>Practices to avoid</i>
To bridge fiscal gap	<ul style="list-style-type: none">• Reassign responsibilities• Tax abatement• Tax base sharing	Tax abatement in Canada and tax base sharing in Canada, Brazil and Pakistan	Deficit grants Tax by tax sharing as in India
To reduce regional fiscal disparities	General Non-matching Fiscal capacity equalization transfers	Fiscal equalization programs of Australia, Canada and Germany	General revenue sharing with multiple factors
To compensate for benefit spillovers	Open-ended matching transfers with matching rate consistent with spillout of benefits	RSA grant for teaching hospitals	
Setting national minimum standards	Conditional non-matching block transfers with conditions on standards of service and access	Indonesia roads and primary education grants Colombia and Chile education transfers	conditional transfers with conditions on spending alone ad hoc grants
Influencing local priorities in areas of high national but low local priority	Open-ended matching transfers (with preferably matching rate to vary inversely with fiscal capacity)	Matching transfers for social assistance as in Canada	ad hoc grants
Stabilization	capital grants provided maintenance possible	Limit use of capital grants and encourage private sector participation by providing political and policy risk guarantee	stabilization grants with no future upkeep requirements

Source: Shah (1994), Boadway, Roberts and Shah (1994)

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